

Internal Revenue Service

memorandum

CC:TL-N-2800-91

Brl:MLOsborne

date: MAY 13 1991

to: District Counsel, Laguna Niguel
Attn: Miles D. Friedman

CC:LN

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This is in response to your request for tax litigation advice dated January 5, 1991. The tax litigation advice involves the tax year [REDACTED].

This response is based upon our understanding of the facts and issues contained in your written request for tax litigation advice and upon information received during our many phone discussions.

ISSUES

1. What is an item within the meaning of Treas. Reg. § 1.472-8 for new cars and trucks.
2. Should used cars and trucks be in separate pools.
3. If separate pools are required for used cars and trucks, is this a change in the method of accounting for which a section 481 adjustment is required.
4. What is the proper method to value the LIFO inflation factor for used cars or trucks.
5. Is the replacement cost method acceptable to value the LIFO inflation factor for parts.

CONCLUSIONS

1. For a retail car dealership, each vehicle may be an item for new cars and trucks; with appropriate adjustments being made to the cost of the vehicle factoring in the year, model, body style, standard equipment, and options. However, for purposes of this case, the definition of an item as a submodel is acceptable. For used cars and trucks, each vehicle in inventory is a separate item.

2. Used cars and used trucks should be in separate pools.

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3. It is our position that a section 481 adjustment may be imposed, but is not mandatory.

4. The method currently used by the taxpayer, comparing cars from the Kelly Blue book for the appropriate aging of the car, is acceptable.

5. Use of the replacement cost method for valuing the LIFO inflation factor for the taxpayer's parts inventory is acceptable.

FACTS

██████████ ("██████") is an automobile dealership located in ██████████. From ████████ through ████████, it sold new and used cars and trucks and serviced ████████ motor vehicles. In ████████, ██████████ opened a ██████████ dealership. ██████████ first elected LIFO for its new cars and trucks and parts inventory in ████████. It elected LIFO for used cars and trucks in ████████. It uses dollar-value LIFO under the link-chain method.

The majority of the inventory records were thrown out covering the period ████████ through ████████. Substantial reconstruction has been accomplished, allowing an accurate identification of vehicles in inventory. However, some information is unavailable with respect to determining option packages on these vehicles for the years in which the records were lost.

Apparently, while there are some inconsistencies in ██████████'s methodology in different years, for the tax year ██████████ identified the model of the new car or truck, and the model of a used car or truck, as an item for purposes of Treas. Reg. § 1.472-8. ██████████ also kept just one pool for used cars and trucks, although new cars and new trucks were kept in separate pools. With regard to the LIFO inflation factor for used cars and trucks, ██████████ compares models of the same age, using the Kelly Blue Book for valuation. Finally, ██████████ currently uses replacement costs rather than historical costs for purposes of computing its LIFO inflation factor for its parts inventory.

DISCUSSION

Section 472(a) permits the use of the LIFO inventory method in inventorying goods if, among other requirements, the LIFO method clearly reflects income. Section 472(b)(2) provides that goods inventoried under the LIFO inventory method must be at cost.

Treas. Reg. § 1.472-8(a) allows an election to determine the cost of the LIFO inventories under the "dollar value" LIFO method, providing the method is used consistently and clearly

reflects income. The dollar-value method is a method of arriving at cost using a "base-year" cost expressed in terms of total dollars as a unit of measurement (rather than quantity and price of specific goods), aggregating the cost of all items in the pool in the base year (the year the LIFO method is adopted). Under this dollar-value method the goods in inventory are grouped into a pool or pools according to the principles of Treas. Reg. § 1.472-8(c).

The principles for establishing a pool or pools under Treas. Reg. § 1.472-8(c) require retailers to place "items" of inventory into pools by major lines, types, or classes of goods. Ordinarily, the "double extension" method for valuing the base year and current year of a dollar value inventory is allowed under Treas. Reg. § 1.472-8(e). However, where the use of double extension is impractical, the regulation allows the use of an index method. Also, the use of the "link-chain" method will be approved where the taxpayer can demonstrate that the use of either the double extension or index method would be impractical or unsuitable in view of the type of pool.

The approval of adoption and the continued use of the LIFO inventory method will be determined by the Commissioner in connection with the examination of the taxpayer's return. Treas. Reg. § 1.472-3(d). The Commissioner has broad powers to determine whether the taxpayer's method of accounting clearly reflects income, and his determinations will be sustained unless the determination was arbitrary and unbridled. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979).

An item for a retailer refers to a finished product of inventory and not to its individual components. Wendle Ford Sales, Inc. v. Commissioner, 72 T.C. 447 (1979), acq., 1980-1 C.B. 1. In Wendle Ford, the Service argued that the addition of a catalytic converter or a solid-state ignition on a 1975 Ford vehicle made the 1975 Ford vehicle a different "item" entering the pool under Treas. Reg. § 1.472-8(e) than the 1974 Ford vehicle, requiring an adjustment to the taxpayer's base-year costs. The Tax Court found that "the differences in the two models are [not] substantially sufficient to warrant the conclusion that the two vehicles are different items for dollar-value LIFO purposes." Wendle Ford, 72 T.C. at 461. Changes and improvements which are substantially sufficient to create a new item are determined by the facts of each case.

The Service agreed that the issue of what is an item is a question of fact, and that the modifications of the catalytic converter and solid-state ignition did not cause the 1975 Ford vehicles to be classified as new items. However, the acquiescence did not foreclose the argument that technological advances and improvements may create a new item, as such

technological changes may be substantially sufficient to create an item.

The Tax Court next dealt with a retail automobile dealer computing inventory for the dollar-value LIFO method in the cases of Fox Chevrolet, Inc. v. Commissioner, 76 T.C. 708 (1981), and Richardson Investments, Inc. v. Commissioner, 76 T.C. 736 (1981). In Fox Chevrolet, the Service argued that each model line of vehicles had to be placed in separate pools. Looking at Treas. Reg. § 1.472-8(c), the Tax Court determined that each model line did not have to be in a separate pool, but that new cars and new trucks had to be placed in separate pools.

The Tax Court rejected the argument of separate pools for each model line, finding new cars, despite differences, sufficiently similar in nature to be of the same general category. The court was influenced by the departmental grouping of the dealership, where new cars and new trucks were operated in separate business divisions.

In Fox Chevrolet, in finding that the new cars and trucks required separate pooling, the court expounded on the differences between cars and trucks:

Although automobiles and trucks share some common characteristics, on balance they are sufficiently dissimilar that we believe each represents a separate and distinct class of goods. Each appeals to a different type of purchaser. The market for automobiles is comprised in the main of persons among the general public who desire to acquire a means of transporting themselves between location, usually within their community and occasionally on extended outings to more distant locales. Trucks, on the other hand, are more often bought for business use. They are principally for transporting property.

Fox Chevrolet, 76 T.C. at 725. In Richardson Investments, the court followed the rationale and holding of Fox Chevrolet requiring separate pooling of new cars and new trucks, noting "the fact that there were more than mere cosmetic differences between the two products [cars and trucks] and that licensing requirements for trucks, both with respect to the vehicle and the operator, can differ." Richardson Investments, 76 T.C. at 748.

Another case dealing with the definition of an item is Amity Leather Products Co. v. Commissioner, 82 T.C. 726 (1984). There, the Tax Court approved of the approach of more narrowly defining an item so as to more accurately reflect income. The Tax Court required the petitioner to treat two divisions which made

billfolds, one in the United States and one in Puerto Rico, as separate items in the pool. This treatment "is obviously a more narrow definition of the term 'item.' Under this approach, the impact of inflation on petitioner's inventory is more accurately eliminated, and its income is more clearly reflected." Amity Leather, 82 T.C. at 740.

Proper definition of an item for new cars and new trucks

The LIFO regulations were written under the assumption that every taxpayer can determine what "items" are in inventory at the end of a taxable year, and that a comparable "item" was in inventory at the end of the base-year, or the preceding year for taxpayers using link-chain. The regulations state that no adjustments are to be made to the cost of an item if the item is on hand at the end of the base-year, or the preceding year if the taxpayer has elected link-chain. When the list of optional equipment for cars is combined with the more than 600 different passenger car models, there is a tremendous number of differently equipped cars that could be on hand at the end of the year. Additionally, yearly changes are made to body style, standard equipment, options, rebates, warranties, features, and other factors. These differences and changes must be considered in making the LIFO computations to avoid gross distortions. The cost of two cars of the same model can vary by thousands of dollars depending on how they are equipped.

The current position of the national office regarding the definition of an item for purposes of calculating the value of inventory under the dollar-value LIFO method is that an item should essentially be each vehicle in inventory. Appropriate adjustments should be made to the cost of the vehicles on hand at the end of the prior taxable year to account for as many factors as possible. The various factors to be accounted for include make, year, model, body style, standard equipment, options, and other factors.

However, for purposes of this case, our litigating position is that an item is a submodel (e.g., Ford Taurus GT is one item, different from Ford Taurus LT). We propose this definition of an item (a submodel) based on the hazards of litigation specific to this case: notably, the reconstruction and the consequent gaps of the inventory records for the years [REDACTED] through [REDACTED]. On the other hand, we do not abandon our general position that a vehicle can be "broken down" into a narrower definition of an item (for instance, a submodel with option package), but feel the submodel definition of an item is better in this case, especially in light of the possibilities of settling the case based upon this determination of an item.

The definition we propose is better for litigating this case for three reasons: it has none of Wendle Ford's components

versus finished product problems; it comports with the Tax Court's narrower definition of an item in Amity Leather; and it imposes no undue record keeping burdens on [REDACTED]. Also, it follows from the intent of the LIFO rules and regulations to accurately reflect proper ending inventory, and thus clearly reflect income. The information to determine an item under this definition is readily available; the submodels have clear base sticker prices. Thus, for purposes of settlement and in this case only, the definition of an item for [REDACTED] is a submodel.

Use of pools for used cars and used trucks

The pooling rules applicable to new cars and trucks should also be applicable to used cars and trucks. In Fox Chevrolet and Richardson Investments, the Tax Court held that the taxpayers, automobile dealerships, must separately pool their new cars and new trucks. Therefore, we believe used cars and trucks should also be in separate pools.

The same rationale which requires separate pooling for new cars and trucks is equally applicable to used cars and trucks. The used cars and used trucks should be in separate pools, each separate again from the new cars and new trucks pools. The significant differences in cars and trucks is not eliminated by the different status of new or used. Used trucks are still more often bought for business use and for transporting of property. Likewise, licensing requirements for the vehicle and the operator apply to used trucks as well as new trucks. Consequently, the used cars and used trucks should be placed into separate pools. The differences are sufficiently significant to justify placing in separate pools for purposes of inventory pricing under dollar-value LIFO. A Technical Advice Memorandum, LTR 8906001 (attached, Issue 2), also relied on Fox Chevrolet and Richardson Investments, determining "that used cars and trucks represent distinct classes of goods and should be placed in separate pools."

Section 481 adjustment

It is our position that, in a situation such as this where the examining agent proposes an adjustment with respect to a LIFO pooling change, a section 481(a) adjustment may be imposed, but is not mandatory. The application of a section 481(a) adjustment is discretionary, and may depend upon the posture of the case in settlement. If no adjustment is imposed, a cutoff would be applied and all prior year LIFO layers would be retained.

Valuation of used cars and used trucks

[REDACTED]'s system of valuing used cars and trucks is acceptable, falling within the system used by the taxpayer in LTR 8906001 (Issue 6). There, the taxpayer used the link-chain method.

Current-year cost of used vehicles in ending inventory was the mean average wholesale book value for that model as a used vehicle in the Kelly Blue Book for November and December of that year. Prior-year cost was the mean average wholesale book value in the Kelly Blue Book for a comparable model vehicle one year older. The Technical Advice accepted that this methodology clearly reflected income, although other methods could also clearly reflect income.

Use of replacement costs method for parts inventory

██████'s use of replacement costs method for valuing its parts inventory is acceptable, identical to the method used by the taxpayer in LTR 8906001 (Issue 4). The Technical Advice concluded that, even though the taxpayer's use of current replacement cost may not in some instances represent "actual cost" incurred during the year, under the facts and circumstances of the case, the use of such method is not grounds for terminating the taxpayer's LIFO election.

It is our understanding that this case may be amenable to settlement. We recommend settling the case based upon the conclusions reached in the above discussion.

If you have any questions, please call Duke Osborne at FTS 566-3521.

MARLENE GROSS

By:



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Attachment:

LTR 8906001